

Orthopaedic Hospital at Parkview North, LLC

Accountants' Review Report and Financial Statements

December 31, 2007



Orthopaedic Hospital at Parkview North, LLC
December 31, 2007

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Accountants' Review Report

Board of Managers
Orthopaedic Hospital at Parkview North, LLC
Fort Wayne, Indiana

We have reviewed the accompanying balance sheet of Orthopaedic Hospital at Parkview North, LLC (Hospital), 70% owned subsidiary of Parkview Health Systems, Inc., as of December 31, 2007, and the related statements of income, members' equity and cash flows for the period from March 30, 2007 (inception) to December 31, 2007, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of Orthopaedic Hospital at Parkview North, LLC.

A review consists principally of inquiries of Hospital personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

BKD, LLP

March 21, 2008

Orthopaedic Hospital at Parkview North, LLC

Balance Sheet December 31, 2007

	<u>2007</u>
Assets	
Current Assets	
Cash and cash equivalents	\$ 2,107,711
Patient accounts receivable, net of allowance of \$35,541	6,819,756
Notes receivable from members	26,527,073
Supplies	12,757
Prepaid expenses and other	<u>392,662</u>
Total current assets	\$ 35,859,959
Property and Equipment, At Cost	
Equipment	2,414,367
Less accumulated depreciation	<u>(179,490)</u>
	2,234,877
Other Assets	
Goodwill	<u>23,720,291</u>
Total assets	\$ <u>61,815,127</u>
Liabilities and Members' Equity	
Current Liabilities	
Current maturities of capital lease obligation	\$ 28,784
Accounts payable	1,681,593
Accounts payable to member	2,453,612
Current maturities of note payable to member	<u>25,029,746</u>
Total current liabilities	\$ 29,193,735
Long-Term Debt, capital lease	60,819
Note Payable to Member	1,012,485
Members' Equity	<u>31,548,088</u>
Total liabilities and members' equity	\$ <u>61,815,127</u>

Orthopaedic Hospital at Parkview North, LLC
Statement of Income
Period from March 30, 2007 (Inception) to December 31, 2007

	<u>2007</u>
Operating Revenue	
Net patient revenue	\$ 6,801,695
Other	<u>115,101</u>
Total operating revenue	\$ 6,916,796
Expenses and Losses	
Salaries and wages	582,114
Employee benefits	183,275
Medical supplies	2,909,914
Drugs	139,608
Depreciation and amortization	179,490
Rent expense	153,628
Purchased services and professional fees	1,394,690
Utilities	34,840
Repairs and maintenance	2,910
Provision for uncollectible accounts	35,541
Other expenses	<u>53,991</u>
Total operating expenses	<u>5,670,001</u>
Operating Income	1,246,795
Other Income, interest	<u>17,960</u>
Net Income	\$ <u><u>1,264,755</u></u>

Orthopaedic Hospital at Parkview North, LLC
Statement of Members' Equity
Period from March 30, 2007 (Inception) to December 31, 2007

	<u>Contributed Capital</u>	<u>Accumulated Earnings</u>	<u>Total</u>
Members' equity contributions	\$ 30,283,333	\$ —	\$ 30,283,333
Net income	<u>—</u>	<u>1,264,755</u>	<u>1,264,755</u>
	<u>\$ 30,283,333</u>	<u>\$ 1,264,755</u>	<u>\$ 31,548,088</u>

Orthopaedic Hospital at Parkview North, LLC

Statement of Cash Flows

Period from March 30, 2007 (Inception) to December 31, 2007

	<u>2007</u>
Operating Activities	
Net Income	\$ 1,264,755
Items not requiring cash	
Depreciation and amortization	179,490
Changes in	
Patient accounts receivable	(6,819,756)
Supplies	(12,757)
Prepaid expenses and other	(392,662)
Accounts payable	1,681,593
Accounts payable to member	<u>2,453,612</u>
Net cash used in operating activities	\$ (1,645,725)
Financing Activities	
Proceeds from member equity contributions	3,756,260
Principal payments on capital lease obligation	<u>(2,824)</u>
Net cash provided by financing activities	<u>3,753,436</u>
Increase in Cash and Cash Equivalents	2,107,711
Cash and Cash Equivalents, Beginning of Period	—
Cash and Cash Equivalents, End of Period	<u>\$ 2,107,711</u>
Supplemental Cash Flows Information	
Asset acquired through capital lease obligation	\$ 92,427
Member equity contributions issued through issuance of notes receivable from members	30,108,333
Purchase of equipment and hospital operations through issuance of note payable to member	26,042,231

Orthopaedic Hospital at Parkview North, LLC

Notes to Financial Statements

December 31, 2007

Note 1: Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations

Orthopaedic Hospital at Parkview North, LLC (Hospital) primarily earns revenue by providing inpatient and outpatient musculoskeletal and related surgical services to patients in the greater Fort Wayne, Indiana area.

Limited Liability Company

The Hospital is organized as an Indiana limited liability company and was initiated on March 30, 2007. The Hospital is owned by two corporate members, Parkview Health Systems, Inc. (Parkview) (70% ownership) and Northeast Orthopaedic Hospital Investors, LLC (NOHI) (30% ownership). Control of most operating decisions of the Hospital is vested in a Board of Managers appointed by the members with some major decisions controlled by one or both members directly. The Hospital will continue until terminated by agreement of the members.

Cash distributions and earnings are allocated to the members based upon their percentage of ownership, as specified in the operating agreement.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Investment Return

Investment return is comprised primarily of interest income earned on the operating cash accounts.

Cash Equivalents

The Hospital considers all liquid investments with original maturities of three months or less to be cash equivalents. At December 31, 2007, cash equivalents consisted primarily of money market accounts, and the Hospital's cash accounts exceeded federally insured limits by approximately \$2,054,000.

Patient Accounts Receivable

The Hospital reports patient accounts receivable for services rendered at net realizable amounts from third-party payers, patients and others. The Hospital provides an allowance for uncollectible accounts based upon a review of outstanding receivables, historical collection information and existing economic conditions. As a service to the patient, the Hospital bills third-party payers directly and bills the patient when the patient's liability is determined. Patient accounts receivable

Orthopaedic Hospital at Parkview North, LLC

Notes to Financial Statements

December 31, 2007

are due in full when billed. Accounts are considered delinquent and subsequently written off as bad debts based on individual credit evaluation and specific circumstances of the account.

Supplies

The Hospital states supply inventories at the lower of cost, determined using the first-in, first-out method, or market.

Property and Equipment

Property and equipment are depreciated on a straight-line basis over the estimated useful life of each asset. Assets under capital lease obligations and leasehold improvements are depreciated over the shorter of the lease term or their respective estimated useful lives.

Goodwill

Goodwill is tested annually for impairment. If the implied fair value of goodwill is lower than its carrying amount, a goodwill impairment is indicated and goodwill is written down to its implied fair value. Subsequent increases in goodwill value are not recognized in the financial statements.

Net Patient Service Revenue

The Hospital has agreements with third-party payers that provide for payments to the Hospital at amounts different from its established rates. Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payers and others for services rendered and includes estimated retroactive revenue adjustments. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered and such estimated amounts are revised in future periods as adjustments become known.

Charity Care

The Hospital provides charity care to patients who are unable to pay for services. The amount of charity care is included in net patient service revenue and is not separately classified from the provision for uncollectible accounts.

Estimated Malpractice Costs

Estimated malpractice costs, if any, include estimates of the ultimate costs for both reported claims and claims incurred but not reported.

Income Taxes

The Hospital is organized as a pass-through limited liability corporation under the Internal Revenue Code. As such, the Hospital is not taxed at the entity level and income is passed through to the members of the Hospital at the individual level. Accordingly, the Hospital does not recognize income taxes in the accompanying financial statements.

Orthopaedic Hospital at Parkview North, LLC

Notes to Financial Statements

December 31, 2007

Note 2: Net Patient Service Revenue

The Hospital has agreements with third-party payers that provide for payments to the Hospital at amounts different from its established rates. These payment arrangements include:

Medicare: Inpatient acute care services and substantially all outpatient services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. The Hospital is reimbursed for certain services at tentative rates with final settlement determined after submission of annual cost reports by the Hospital and audits thereof by the Medicare fiscal intermediary.

Medicaid: Inpatient acute care services and substantially all outpatient services rendered to Medicaid program beneficiaries are paid at prospectively determined rates per discharge.

These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors.

The Hospital has also entered into payment agreements with certain commercial insurance carriers, health maintenance organizations and preferred provider organizations. The basis for payment to the Hospital under these agreements includes prospectively determined rates per discharge, discounts from established charges and prospectively determined daily rates.

Note 3: Medical Malpractice Coverage and Claims

The Hospital purchases medical-malpractice insurance under a claims-made policy on a fixed premium basis. Accounting principles generally accepted in the United States of America require a health care provider to accrue the expense of its share of malpractice claim costs, if any, for any reported and unreported incidents of potential improper professional service occurring during the year by estimating the probable ultimate costs of the incidents. Based upon the Hospital's claim experience, no such accrual has been made. It is reasonably possible that this estimate could change materially in the near term.

Note 4: Long-Term Debt

	<u>2007</u>
Capital lease obligations	\$ 89,603
Less current maturities	<u>(28,784)</u>
	\$ <u>60,819</u>

Capital lease obligations, payable in monthly installments of \$2,824 with an imputed interest rate of 6.7%. The lease is secured by the leased equipment. The lease term is three to six years. Property and equipment include the following property under the capital lease arrangement:

Orthopaedic Hospital at Parkview North, LLC

Notes to Financial Statements

December 31, 2007

	<u>2007</u>
Equipment	\$ 92,427
Less accumulated depreciation	<u>(5,135)</u>
	<u>\$ 87,292</u>

Aggregate annual payments on capital lease obligations at December 31, 2007, are:

2008	\$ 33,891
2009	33,891
2010	<u>31,067</u>
	98,849
Less amount representing interest	<u>(9,246)</u>
Present value of future minimum lease payments	89,603
Less current maturities	<u>(28,784)</u>
Noncurrent portion	<u>\$ 60,819</u>

Note 5: Operating Lease to Member

The Hospital leases its facility from Parkview. A noncancellable operating lease for the Hospital facility expires in October 2017. The original lease amount is \$88,364 per month and is adjusted at the start of each lease year by an inflationary factor based on the Consumer Price Index. The lease contains renewal options for periods ranging from five to ten years, and requires the Hospital to pay all executory costs (property taxes, maintenance and insurance).

Future minimum lease payments (without consideration of future inflation adjustments) at December 31, 2007, were:

2008	\$ 1,060,368
2009	1,060,368
2010	1,060,368
2011	1,060,368
2012	1,060,368
Later years	<u>5,125,112</u>
Future minimum lease payments	<u>\$ 10,426,952</u>

Total lease expense for 2007 totaled \$153,628.

Orthopaedic Hospital at Parkview North, LLC

Notes to Financial Statements

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Note 6: Note Payable to Member

The Hospital purchased all hospital operations and certain equipment from Parkview on November 8, 2007, for \$26,042,231, and issued a note to Parkview for the entire purchase amount which has not been paid as of December 31, 2007. \$24,917,248 of the note is due when the Hospital has satisfied all conditions and received all approvals for operation, which occurred on February 8, 2008. The note is secured by all purchased assets. The remaining \$1,124,983 is due ratably over a ten-year period ending in 2017. The note bears stated interest at 4.5%, which is to be waived for all future periods and thus has not been accrued at December 31, 2007.

Aggregate annual payments on the note at December 31, 2007, are:

2008	\$ 25,029,746
2009	112,498
2010	112,498
2011	112,498
2012	112,498
Thereafter	<u>562,493</u>
	<u>\$ 26,042,231</u>

The \$24,917,248 portion of the note was paid on February 25, 2008.

Note 7: Notes Receivable from Members

The Hospital was formed in April 2007 and was capitalized in October 2007 by member contributions of \$21,198,333 from Parkview and \$9,085,000 from NOHI. These contributions were partially funded by notes receivable issued by the Hospital to its members in the following amounts, which were still outstanding at December 31, 2007:

Parkview	\$ 17,442,073
NOHI	<u>9,085,000</u>
	<u>\$ 26,527,073</u>

The notes are due when the Hospital has satisfied all conditions and received all approvals for operation, which occurred on February 8, 2008. The notes bear stated interest at 4.5%, which is anticipated to be waived and thus has not been accrued at December 31, 2007.

The notes were paid on February 11, 2008.

Note 8: Related Party Transactions

In October 2007, the Hospital entered into a Purchased Services Agreement with Parkview to provide certain staffing, management, administrative and payroll related services for the Hospital.

Orthopaedic Hospital at Parkview North, LLC

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The agreement has an initial term of three years, and is renewable in one-year increments after the initial term unless terminated by either party. Costs associated with the services are set by various methodologies designed to approximate fair market value amounts for the services. Expense paid by the Hospital to Parkview under this arrangement in 2007 was \$2,453,612, which was outstanding in total as accounts payable to member at December 31, 2007.

Note 9: Acquisition of Hospital Operations from Member

On November 8, 2007, the Hospital acquired all of the operations and certain equipment of the Orthopaedic Hospital division of Parkview North Hospital, Inc., a wholly controlled affiliate of Parkview. The results of the acquired entity have been included in the results of operations since that date. No assets or liabilities other than the certain equipment were purchased in the transaction. Concurrent with the purchase of hospital operations, the Hospital entered into a building lease and Purchased Services Agreement with Parkview under which facilities and services are obtained from Parkview at fair market rates. The purchase price of the acquisition was \$26,042,231, and was capitalized by the Hospital as follows:

Equipment	\$ 2,321,940
Goodwill	<u>23,720,291</u>
	<u>\$ 26,042,231</u>

The goodwill acquired is partially deductible for tax purposes.

Note 10: Commitments and Contingencies

Line of Credit

The Hospital is a party to a line of credit with a bank providing up to \$5,000,000 in borrowings. The line of credit agreement expires December 2008, and requires interest only payments on any outstanding balance. The agreement is secured by the Hospital's accounts receivable. The Hospital did not have any outstanding amount owed to the bank at December 31, 2007.

Litigation

The Hospital is subject to claims and lawsuits that arise primarily in the ordinary course of its activities. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits will not have a material adverse effect on the financial position, change in net assets and cash flows of the Hospital. As such, no accrual for such losses has been recognized in the accompanying financial statements. It is reasonably possible this estimate could change materially in the near term.

Orthopaedic Hospital at Parkview North, LLC

Notes to Financial Statements

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Note 11: Significant Estimates and Concentrations

Accounting principles generally accepted in the United States of America require disclosure of certain significant estimates and current vulnerabilities due to certain concentrations. Those matters include the following:

Allowance for Net Patient Service Revenue Adjustments

Estimates of allowances for adjustments included in net patient service revenue are described in *Notes 1 and 2*.

Malpractice Claims

Estimates related to the accrual for medical malpractice claims are described in *Notes 1 and 3*.

Admitting Physicians

The Hospital is served by a group of admitting and surgical physicians that comprise nearly 100% of the Hospital's net patient service revenue. The physician group is a related party of the Hospital through common ownership of NOHI.